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## UPDATE

October 2006

### *Fuel for the Markets*

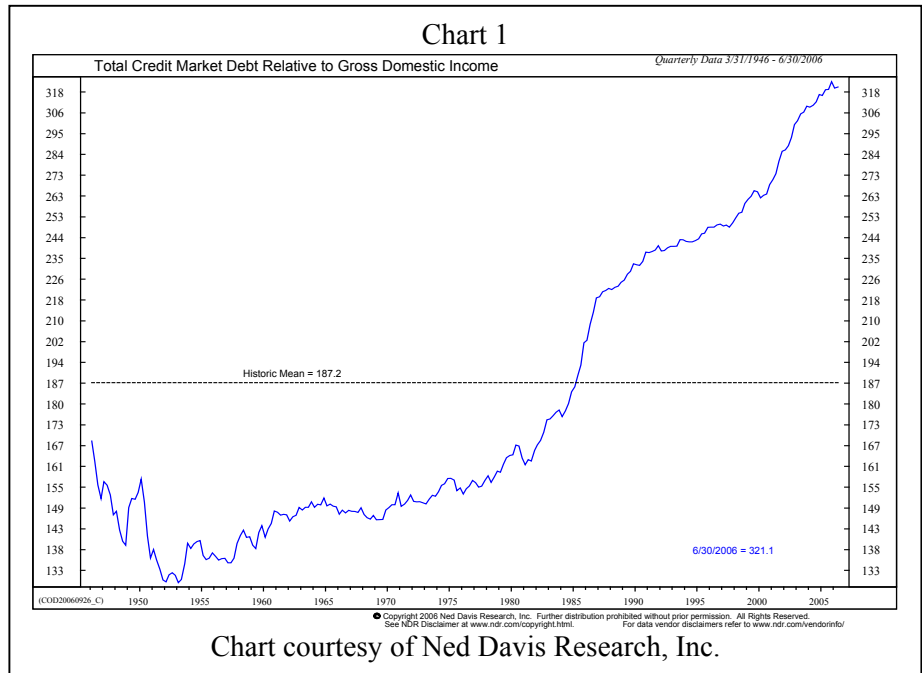
We have just concluded one of the best third-quarter market performances in recent history. The fuel for this rally has, in large part, come from falling energy prices and a bond market rally that sent 10-year Treasury yields from a closing peak of 5.23% on June 26, 2006, to 4.655% on September 30, 2006. The market is betting that these events will stimulate economic activity by giving consumers more spending money and lowering the cost of borrowing for businesses, investors and consumers alike.

The weakness of recent economic data and some signs of decelerating growth in inflation have bond market participants betting the Federal Reserve will soon lower the Fed funds rate to stimulate economic growth. In his October 2006 *Investment Outlook*, Bill Gross, Managing Director for PIMCO, says his “best...bet is a cyclical one that proposes that the Fed is done and ultimately will have to lower interest rates in order to re-stimulate [the] economy.” But while the bond market is showing clear conviction in its outlook, recent Fed speeches are not exactly supportive of this stance. In a September 16-17, 2006 article in the *Wall Street Journal* entitled, Outlooks Divide the Fed, the Street, Greg Ip writes that Fed officials “do not share the pessimism on growth, or the optimism on inflation, implicit in [market] expectations of a rate cut by mid-2007. Ip believes traders are misreading the Fed’s thoughts on growth and inflation. During an October 4, 2006 speech given to the Money Marketeters of New York University, Federal Reserve Vice Chairman Donald Kohn warned the markets not to “sell the Fed’s concern about inflation short. Mr. Kohn added that he is “surprised” at how little market participants seemed to be concerned with inflation.

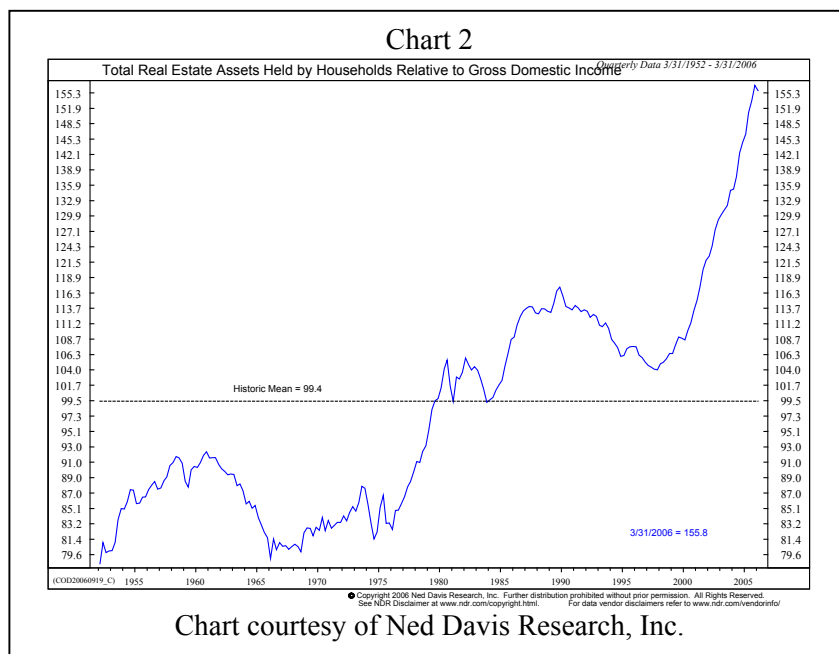
Tom Gallagher of ISI Group, Inc. (who has been deadly accurate with his Fed forecast this year) recently wrote that he feels “inclined to take the two first-half 2007 rate cuts out of his forecast.” Gallagher believes there is evidence the Fed has lowered its estimate of potential annualized GDP growth to around 2.5%. He believes economic growth of 2.5% delivers the small output gap (defined as the difference between actual and potential economic growth) the Fed is counting on to contribute to a drop in core inflation to its comfort zone. In other words, even with cooperative inflation measures 2.5% growth wouldn’t be enough to prompt a rate cut. “Markets have already priced in two rate cuts for 2007. It may be because markets don’t fully appreciate the Fed’s likely posture, but more likely the market anticipates weaker growth.”

While we tend to agree with Gallagher’s view, the decline in bond yields nonetheless provides equities with some running room which could possibly last through year-end. Yet, even as this rally has taken the Dow Jones Industrial Average to new highs, we are monitoring the potential for an economic growth scare stemming from the very stimulus the market is currently cheering.

Among our concerns is the impact the decline in bond yields will have for an economy that is already burdened with debt (see Chart 1). While an argument can be made that lower rates are a key driver of expansion for an economy with such a leveraged balance sheet, we wonder how much more debt can be layered on. Perhaps more than we think. After all, there is little evidence to suggest that the previous 425 basis point (4.25%) increase in the Fed Funds rate to 5.25% had any impact on slowing corporate debt growth. According to a September 12, 2006 *Wall Street Journal* article by Michael

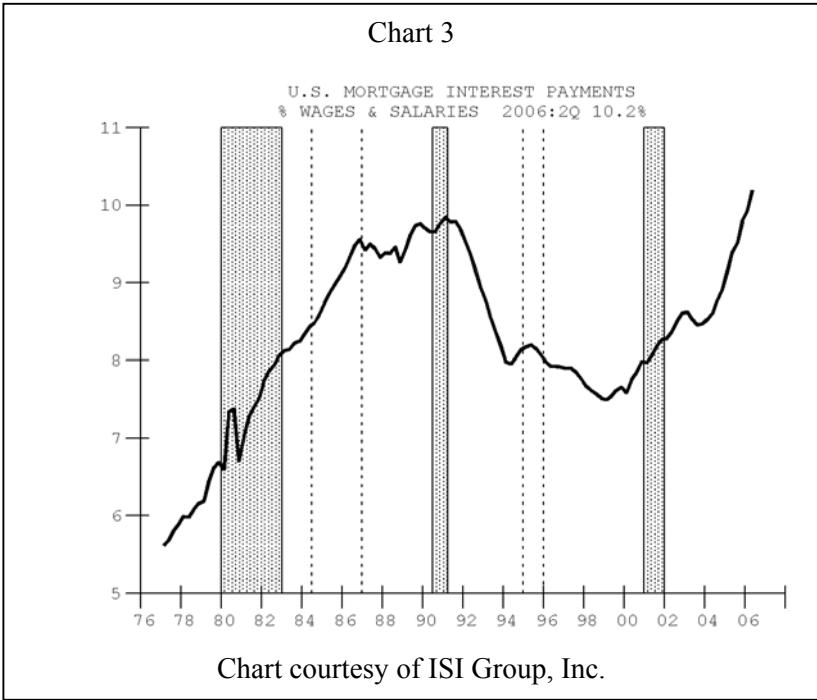


Hudson entitled, Despite the Fed’s 17 Rate Increases, Loans to Businesses Remain Brisk; Worried Regulators May Step In, in the 12 months to Aug 31, 2006, companies issued \$802 billion in investment-grade bonds, a 13% increase from the previous 12-month period. In August alone, corporations issued \$66 billion in investment-grade bonds, a record for the month. “Credit is about as ample as it’s ever been,” says Mark Zandi, chief economist for Moody’s web site [www.Economy.com](http://www.Economy.com). “It’s across the board. It’s not one product class or asset class – it’s everywhere.” To wit, Stephanie Pomboy of MacroMavens writes, “stupid money abounds, as evidenced by this week’s story about the resurgence of ‘blank check’ IPO’s (which raise money for no stated purpose).”



Such robust debt growth comes as a bit of a surprise given that the bond market is anticipating economic weakness that certainly is not indicated by the loan growth figures. Perhaps the bond market is more focused on the weakening housing sector, where Fed tightening has had much more of an impact.

Will the bond market’s lower-rate prescription heal housing’s pain? According to Ned Davis of Ned Davis Research, Inc., the decline in housing market fundamentals has been centered around affordability. Chart 2 depicts the value of household real estate in relation to all domestic

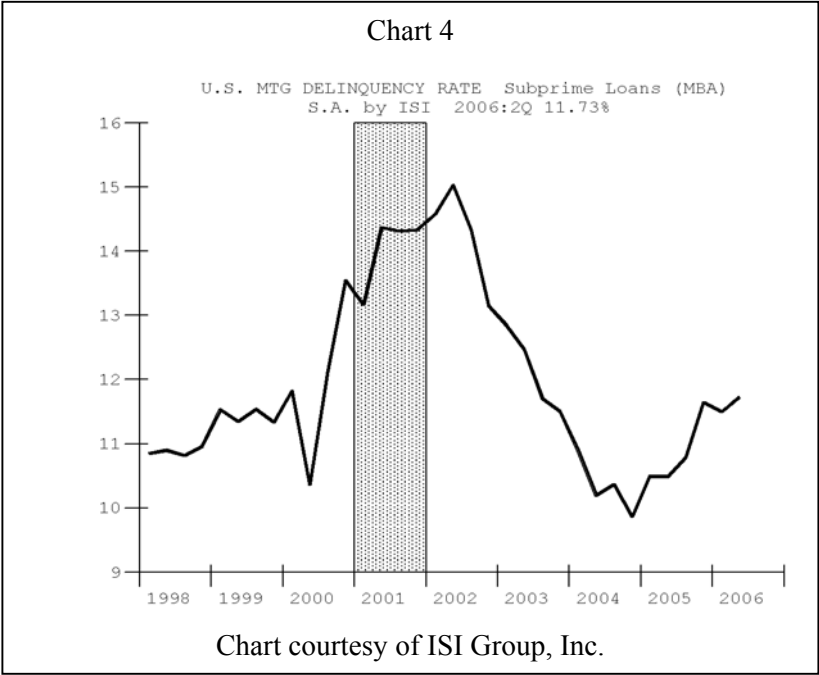


household income as detailed in the Fed’s gross domestic product (GDP) report. While Ned has many specific concerns for the economy, his primary concern is his “belief that the affordability problem in housing has more to do with home prices relative to income rather than interest rates.”

And just as the bond market is trying to give housing a helping hand, regulators appear poised to take long-overdue action on the loosey-goosey lending standards that have prevailed in the mortgage industry over the last several years. What an opportune (if not predictable) time for regulators to finally tune in. The potential changes to mortgage regulations we wrote about in our September 2006 *Update* have now

been released. According to ISI, the new guidelines will take effect immediately. They mandate that financial institutions “demonstrate that mitigating factors support the underwriting decision and the borrower’s repayment capacity” when making nontraditional mortgage loans in which the borrower defers paying principal, or loans with other risky features such as stated income or simultaneous second-liens. Andy Laperriere of ISI believes that these new guidelines will result in a “meaningful number of people who could borrow on very loose terms [not being] able to do so in the coming months...putting further downward pressure on housing.”

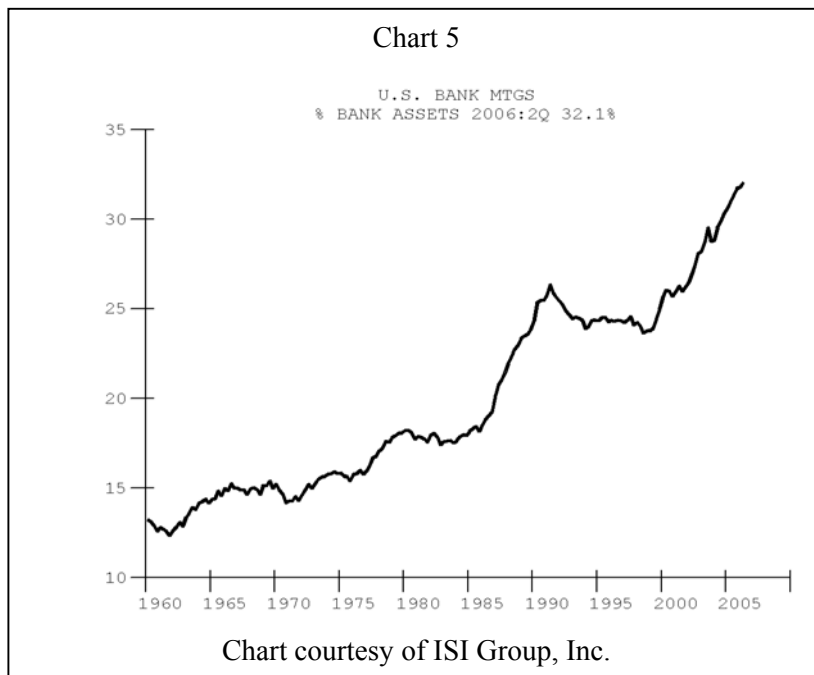
In this environment, our long-held concerns regarding the consumer’s reliance on debt and housing market gains remain unchanged. At a time when new regulations are poised to stem the flow of liquidity into the mortgage markets, consumers are facing the highest level of mortgage payments as a percent of their income in the last three decades (see Chart 3). Unfortunately, as the up-tick in mortgage delinquency rates shows (see Chart 4), the new lending guidelines are perhaps a bit too late for consumers who were given loans for which they otherwise could not have qualified for houses they could not afford. To be sure, it is not just



consumers who will suffer from lenders' past indiscretions. Bank holdings of mortgage loans are now at all-time highs (see Chart 5) and, according to ISI, a decline in the University of Michigan's housing survey has historically been bad news for shares of mortgage issuers. While we opened October 2006 with a net long market exposure, we maintain short exposure to mortgage-centric financial stocks.

In closing, we recently asked Ned Davis' research team if they could tell us how long it has been since the last 10% decline in the S&P 500. The answer: three-and-a-half years. Their study showed that since 1928, the stock market averaged a 10% correction every seven months. Over the last 10-years, a 10% correction has occurred every 12 months, still not close to a three-and-a-half year "safe zone." Of course, this does not mean we will have a 10% correction any time soon, but it does suggest that investors should be wary. We are.

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